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TREASURY FOR VIMAL ATUKORALA
USEU FOR TREASURY ATTACHE

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TAGS: ECON EFIN CY

SUBJECT: INFLATION CONCERNS OF CYPRUS CENTRAL BANK GOVERNOR

Classified By: AMB R SCHLICHER FOR REASONS 1.4 B AND D

1.(C) During a conversation with econoff on July 7, Central Bank of Cyprus Governor, Athanasios Orphanides, lamented Cyprus' inflation (CPI) rate had grown to an annualized 5.2 percent in June, more than 1 percent above that of the Eurozone as a whole, and stated that he expects inflation to reach 6 percent by year-end. He accused the Finance Minister of "acting like a politician" due to his refusal to slow government spending in response to the problem. The Governor cited the government's increasing payments to pensioners, regardless of their income, and an increase in civil servant wages (over and above the bi-annual cost of living adjustment) as two specific examples of GOC programs that are spurring domestic inflation.

2.(C) Orphanides noted that, even after last week's 25 basis point increase in the marginal lending rate by the ECB, real interest rates in Cyprus are likely negative, and this has helped spur a 35 percent annualized increase in borrowing from local banks. With his ability to control monetary policy and bank reserve requirements limited by the ECB, Orphanides expressed clear frustration with the government's "populist" approach to the problem of inflation, which they have blamed on exogenous issues such as the global rise in oil and commodity food prices. The Governor believes that with GDP continuing to grow about 3.5 percent and so much of the workforce protected from economic cycles by working for the government, semi-government organizations, or the big banks (which generally follow government wage polices), Cypriot consumers remain full of confidence and will, therefore, continue to consume at record levels. Thus, he concludes, it is up to the government to adjust its fiscal policies.

3.(C) Comment: Orphanides is a lone voice of economic concern in Cyprus. As he told us, "all the government from the President down is only interested in solving the Cyprus problem. No one is watching the economy." While this may be over-stating the problem, there is no denying that Cyprus' inflation is 25 percent above that in the rest of the Eurozone and there has not been a whisper of any plans by the government to rein it in. In fact, when Orphanides suggested that wage increases be tied to productivity growth rather than automatically to increases in CPI, he was severely criticized by the leader of the President's political party in the Parliament; and no government official came to his defense. We expect that inflation would have to get significantly worse before this government, dedicated to "a more just society," would try and tackle the problem.

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